THE MISSOURI BUDGET

FY 2003 BUDGET SUMMARY

RECOVERING FROM TERRORISM

Missouri and all of the other states are struggling through staggeringly difficult economic times. The economy officially went into recession in March 2001. During the summer of 2001 all major national forecasters envisioned an economy that would begin growing again during the last half of calendar year 2001 with substantial growth during calendar year 2002. However, the terrorist attacks of September 11 have delayed economic recovery and made it likely that such recovery will be slower and weaker than hoped. These events have knocked askew the state's fiscal underpinnings.

Governor Holden entered office one year ago and was immediately faced with a budget that had to be cut. In his first year of office Governor Holden took decisive action to balance the budget.

During Fiscal Year 2001 in his first six months of office he:

- Withheld $76 million in state agency operating budget spending.
- Redirected $126.9 million in tobacco settlement proceeds to help pay for the escalating cost of the senior prescription drug tax credit.
- Changed state expenditure practices to prevent end of year spending by state agencies.
- Maximized federal revenues.

In Fiscal Year 2002 he:

- Core cut $196.6 million from the budget – the most in Missouri history.
- Withheld $200.3 million in state agency operating budget spending in Fiscal Year 2002.
- Withheld $140.7 million in capital improvements spending, mostly for higher education construction.
- Withheld $82.5 million in spending from the tobacco settlement and redirected that money to general revenue.
- Redirected $78.5 million in funds from other state accounts to general revenue.
- Vetoed $26.5 million from the budget.
- Reduced tax credits by $7.5 million.

The continued recession and the economy's reaction to the terrorist attacks have forced Missouri, and most other states, to take strong budget action to ensure a balanced budget. While the federal government is allowed to run a deficit, Missouri state government must balance its budget each year. Like Missouri families, our state government must live within its means. In Fiscal Year 2002, Governor Holden has taken $536 million in actions since the General Assembly passed the budget last May to ensure that the state's budget is balanced. The Governor's budget actions have been guided by several principles. First, K-12 education will be protected at all costs. Second, Missouri's most vulnerable citizens – children and the elderly – will be protected to the greatest extent possible. Third, public safety and corrections are essential to protecting our citizens from crime and will be preserved. Missourians can see the effect of the Governor's priorities in the services that they receive. Administrative cuts have been deep. K-12 education has been protected. Vacancies in staff in our correctional institutions have been filled to ensure the safety of our correctional officers and the security of our citizens.

Missouri's actions and the Governor's values can be put into perspective by seeing how other states are responding to severe economic times. Across the country state governments are tightening their belts. Education has suffered substantial budget cuts in Florida, Arizona, Iowa, Kansas, and California. Prisons are being closed in Michigan, Ohio, and Kansas. Medicaid funding is being cut. State governments are holding vacancies open, if not actually laying off state workers, and are reducing or eliminating employee pay increases.

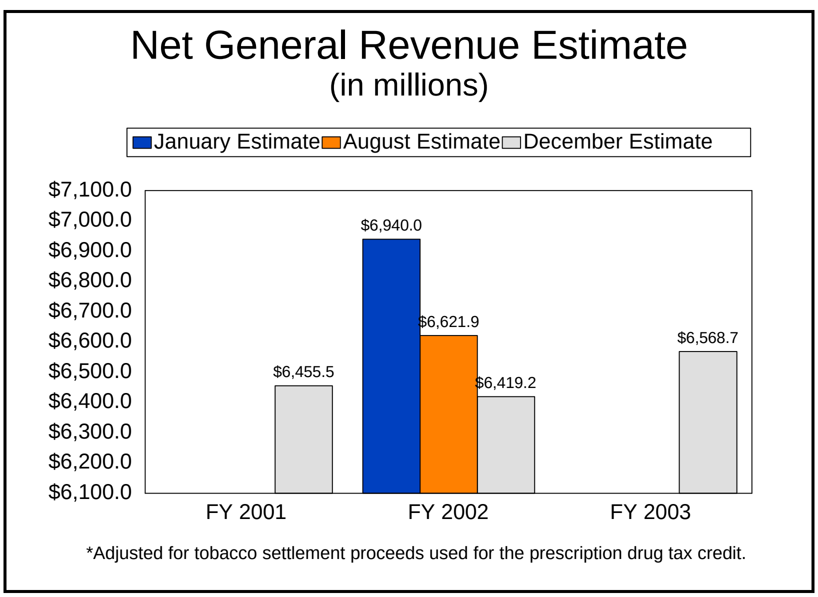
In his first year of office, Governor Holden has taken $612 million in budget actions. While he expects and hopes that these actions are sufficient, the Governor stands prepared to take additional action to ensure a balanced budget. The Fiscal Year 2003 budget presents the most difficult challenge to face the Governor and the General Assembly since the recession in the early 1990s. The chart below reveals the depth of the state's financial difficulties that face the Governor and the General Assembly:

- Fiscal Year 2002 net general revenue collections are now estimated to be $6,419.2 million, a total of $520.8 million below the $6,940 million on which the budget is based.
- Fiscal Year 2002 net general revenue collections are now estimated to be $36.3 million below those actually received in Fiscal Year 2001, a .6 percent decline.
- Fiscal Year 2003 net general revenue collections will increase by $149.5 million over projected the final Fiscal Year 2002 estimate, a relatively anemic 2.3 percent growth.
- Fiscal Year 2003 net general revenue collections will be $371.3 million below the amount needed to support the budget approved for Fiscal Year 2002.

Therefore, the state must cut $371.3 million from the budget even before it can consider funding any new items or continuing support of priority programs such as the Foundation Formula for public schools. However, as in year's past, the state faces large increases in the cost of essential programs in Fiscal Year 2003. These increases must be paid for with even more cuts to the core budgets. Health care costs in the Medicaid program and for state employees are rising dramatically. The Department of Social Services (DSS) requested a $281 million general revenue increase in the Medicaid budget, 34 percent. Since both the cost of drugs and their use is increasing, the DSS request included 26 percent growth in the Medicaid pharmacy budget prior to discounting for cost containment efforts. These costs must be met to ensure continuation of services to Medicaid recipients, the majority of whom are elderly, disabled, or young children. Similarly, in calendar year 2001 the prison population grew by 3.59 inmates per day, a total of 1,311 inmates. This continuing growth will require the opening of the new prison at Bonne Terre.

CORE BUDGET REVIEW

As State Treasurer, Bob Holden focused on increasing the state's return on its investment. As Governor, Bob Holden wants Missouri government to be similarly focused on results and accountable to taxpayers. Missouri has been recognized as one of the best-managed

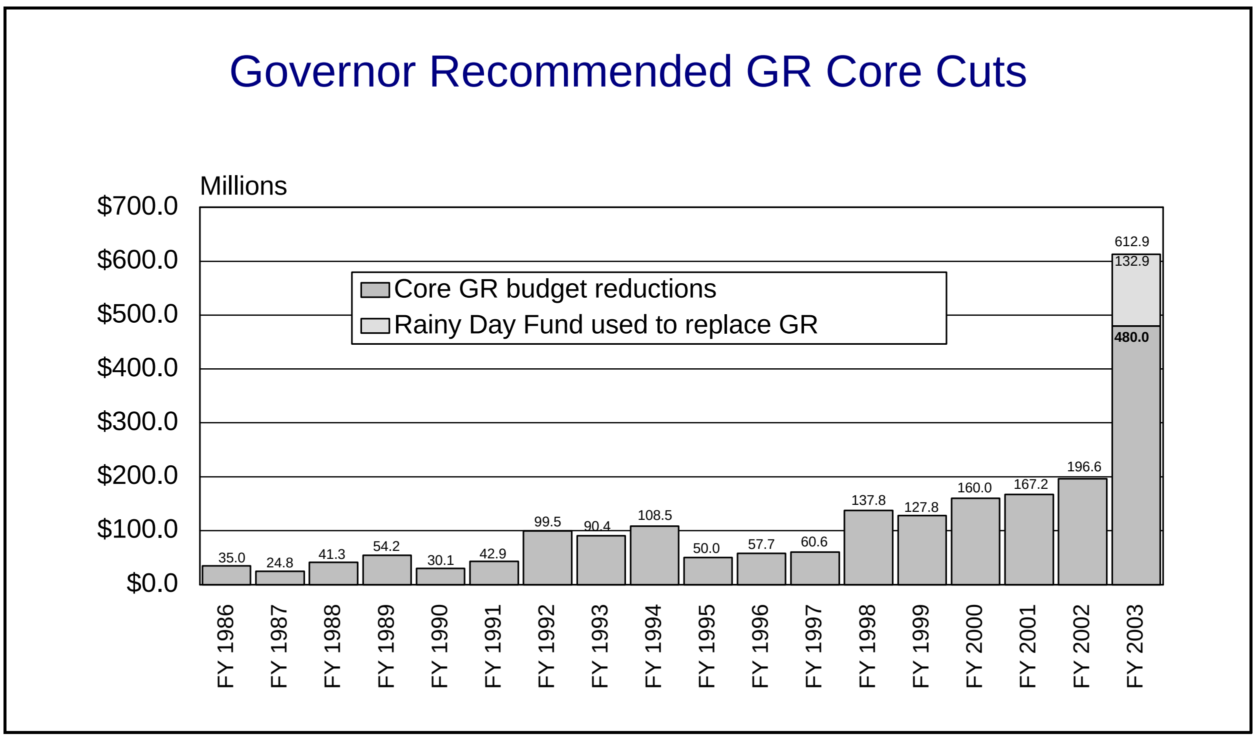


states in the nation, most recently by *Governing Magazine*. In addition, our Managing for Results efforts were rated as one of the five best in the nation. However, one of the distinguishing characteristics of the best performing organizations – whether they are private or public – is the recognition that they can be even better.

In mid-2001 Governor Holden exercised his leadership by directing the state budget office to conduct the most thorough review ever done of the state budget. The Governor demanded that the "core review" be performance based by examining the results that are being achieved by each state program. Governor Holden is committed to reviewing the core budget every year. The core cuts and efficiencies that balance the Fiscal Year 2003 budget could not have been identified without this thorough and exhaustive process. The state budget office and the Governor's Cabinet Director reviewed all general revenue programs – their purpose, funding, and results. The departments of state government were asked to submit "core" reduction plans of 5 percent, 10 percent, and 15 percent with an explanation of the impact of losing funding.

The result of the most extensive "core" review in the state's history is $612.9 million in budget cuts, bringing the Governor's two year core cut total to $809.5 million. As the chart below shows, the Fiscal Year 2003 budget cuts are more than ever previously recommended. The Governor recommends that $132.9 million of the core reductions be replaced with budget reserve funds on a one-time basis in Fiscal Year 2003. State government will be smaller with 688 fewer employees, but Governor Holden demands that the departments of state government continue to provide quality service by working smarter and more efficiently. Missouri remains a low tax state – ranked 47th in state government expenditures per capita. Governor Holden is committed to maximizing taxpayers' dollars by demanding that state government operate on a business model where managers are held accountable for results.

Governor Holden has dramatically changed the focus of state government. He has established that fully funding the foundation formula for K-12 education is the most important priority of his administration. Whole programs have been eliminated and others have been reduced by 25



percent or more. General revenue in the state Medicaid program has been reduced by $30.8 million even though mandatory general revenue increases total $157.5 million. The general revenue reduction in Medicaid has been accomplished by aggressive cost containment initiatives, reducing eligibility, maximizing use of other funds, and reducing payment levels. See the Department of Social Services section of the Missouri Budget for more information on the cost containment initiatives.

RAINY DAY FUND – PROTECTING THE MOST VULNERABLE

Unfortunately, many of the core cuts that are required to balance the budget put our most vulnerable Missourians at risk. This is because 25.2 percent of the general revenue budget is spent on human services. During the core review process the Governor sent state budget officials back to the drawing board several times to look for core cut options that spared the most vulnerable from service reductions. The Governor has identified $132.9 million in general revenue budget cuts needed to balance the budget that he believes compassionate Missourians will agree go too far. In addition, $2.1 million is needed to implement priority health care legislation. The Governor recommends that $135 million of the state's "Rainy Day" Fund be used to pay for these services in Fiscal Year 2003. These services cannot be supported by current revenue sources. Though critical to these Missourians, they are not services that a state has no option but to provide. However, these services include things that a modern, just and humane society should provide to those less fortunate among us. The Governor has protected these critical services by providing a revenue source – the "Rainy Day" Fund - to be used as a bridge to a better economy and a permanent solution for funding these services.

The table below summarizes the services included in the Governor's recommendation.

Budget Reserve Fund Recommendations

Elementary and Secondary Education	
Personal Care Assistance	$4,002,175
Transportation	
Transit funding	7,531,179
Elderly and handicapped transportation	1,349,341
AMTRAK	4,825,000
Port authority assistance	400,488
Mental Health	
Alcohol and drug abuse treatment services	15,796,627
Comprehensive psychiatric community services	56,048,544
Community programs for the developmentally disabled	20,450,631
Health and Senior Services	
Home and community services program and grants	22,462,164
Lupus (HB 106)	58,987
Expanded newborn screening (HB 279)	868,076
Family care safety registry (SB 48)	106,678
Quality monitoring (HB 316 & SB 326)	275,102
Social Services	
Presumptive eligibility	770,080
Expanded newborn hearing screening (HB 401)	54,928
Total	$135,000,000

The Governor recommends that a separate appropriations bill be created to contain all of the funding for these items – HB 1114. A separate bill will facilitate the two-thirds approval of the General Assembly required by Article IV, Section 27 (a) of the Missouri Constitution. In addition, a separate bill will ensure that all Missourians and lawmakers can see how the "Rainy Day" Fund is being used. The National Conference of State Legislatures reports that at least 24 states are considering or have already used reserves to balance their budgets. The number is likely to get higher as governors across the country introduce their proposed budgets over the next few weeks.

In November 2000 the voters of Missouri approved creating a Budget Reserve Fund by combining the state's Cash Operating Reserve Fund and the Budget Stabilization Fund (commonly called the "Rainy Day" Fund). The fund is required to have 7.5 percent of the previous year's net general revenue collections. The fund had a $458.4 million balance at the beginning of October 2001. Under the state's constitutional provisions, the Governor, with two-thirds approval by the General Assembly, can use up to one-half of the fund for "rainy day" purposes. However, as permitted by law, the state used $280 million from the fund in Fiscal Year 2001 for cash flow purposes. The state repays this cash flow loan with interest by May 15 each year. The state expects to use up to $300 million in Fiscal Year 2002 for cash flow purposes. Therefore, from a fiscally prudent standpoint, only about one-third of the Budget Reserve Fund can ever be used for "rainy day" purposes -- about $152.8 million. The Governor recommends using $135 million and leaving $17.8 million in the fund that could be used for "rainy day" purposes at a later time. During the Great Flood of 1993 the state used a roughly equivalent amount - $16 million - from the "rainy day" fund to weather the storm. The remaining balance in the fund should provide sufficient reserves to cope with a similar natural disaster.

Governor Holden recognizes that the "rainy day" fund only provides one-time revenues for these ongoing services. Indeed, the state constitution requires that any use for a "rainy day" be repaid to the fund in payments of one-third over three years. Therefore, the Governor's recommendations would require a $45 million repayment plus interest to the "Rainy Day" Fund in Fiscal Year 2004 to Fiscal Year 2006. The repayment can take place more quickly at the discretion of the Governor and the General Assembly.

TOBACCO SECURITIZATION

A number of state's have sold their tobacco settlement proceeds in a process called "securitization." Tobacco securitizations are similar to a revenue bond borrowing. New York City issued the first tobacco revenue bonds in November 1999. In Missouri, the Board of Public Buildings would sell bonds secured by the rights to the future stream of tobacco settlement payments. The state would then receive a large one-time payment that could be used for any purpose approved by the Governor and the General Assembly.

The Governor supports legislation that would allow the state to securitize Missouri's tobacco settlement proceeds. Having used a large portion of the "Rainy Day" Fund, it is appropriate to give the state another mechanism to raise one-time revenues that could be used for one-time purposes. In the current national economic crisis, several states have securitized large amounts of tobacco settlement proceeds and have funded ongoing, multi-year appropriations. States that have adopted this short-term practice have seen their bond ratings downgraded thus creating higher costs for any borrowing which is not acceptable for Missouri because it is one of only nine states with a triple-A bond rating from each of the three major bond rating firms.

FISCAL YEAR 2003 SUMMARY OF RECOMMENDATIONS

The Fiscal Year 2003 budget balances resources and obligations based on the consensus revenue and refund estimate. The Governor directed the most thorough review of core budgets in the history of Missouri state government. This review identified $612.9 million in general revenue core budget reductions and redirections. The Governor recommends that $132.9 million of the core reductions be replaced with budget reserve funds on a one-time basis in Fiscal Year 2003.

Fiscal Year 2003 base operating appropriations after core cuts are $5,937.3 million.

New operating budget appropriations of $332.9 million are recommended to continue high priority existing programs, cover increasing Medicaid caseloads and costs, address security needs, respond to the expected growth in prison inmate population, and provide for increased state employee health care costs.

This brings the total general revenue operating budget to $6,270.2 million, exclusive of court-ordered desegregation spending, tax refunds, and revenues dedicated to the Outstanding Schools Trust Fund.

The Fiscal Year 2003 cost for the desegregation settlement is $20 million.

A total of $90 million has also been set aside for supplemental appropriations and increases in estimated appropriations.

MISSOURI'S FOUNDATION FORMULA FOR LOCAL SCHOOLS

Governor Holden's number one priority is to provide an additional $219.4 million to fully fund the Foundation Formula – the primary assistance program for Missouri's 524 public school districts. Full funding of the Foundation Formula will assist public school districts in providing vital services while demonstrating our commitment to equip Missouri students with the tools they need to succeed in school. This is critical to ensure that Missouri is on track to becoming a leader among states in education. Full funding of the Foundation Formula provides funds to:

- Improve student academic achievement.
- Increase teacher salaries, which helps retain and attract qualified teachers.
- Assist with increasing operating costs outside the control of the district, such as utilities, supplies, and insurance.
- Provide professional development opportunities to teachers and school administrators.
- Provide resources for school districts to improve curriculum.
- Lower class sizes.

If not funded, school districts would encounter difficulties in retaining and attracting qualified teachers, keeping class sizes low, providing remediation and enrichment programs that help students succeed, and updating classes that will prepare students for the 21st century.

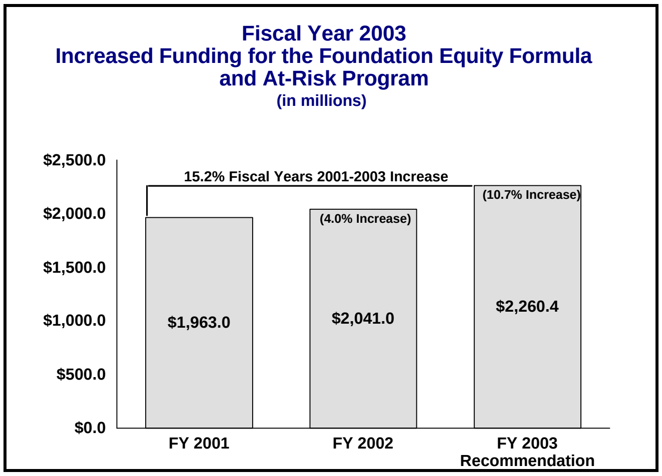
The Governor's plan to provide full funding for the Foundation Formula includes new revenue initiatives from riverboat gaming, the state lottery, and technical changes in the administration of the state sales tax. These initiatives include:

Riverboat Gaming – $156.5 million. The Governor's plan will increase the average net effective tax rate on Missouri boats to approximately the average effective tax rate in Illinois.

- 2% increase in tax on riverboat gaming receipts – $31.5 million. The current adjusted gross receipts tax is 20 percent which is shared by the state (18 percent) and the local governments where the riverboats are docked (2 percent). The Governor's proposal raises the state share to 20 percent and leaves the local share at 2 percent.
- $1 increase in riverboat gaming admission fee - $50 million. The current $2 admission fee will be increased by $1 under the Governor's proposal.
- Eliminate loss limits on riverboat gaming - $75 million. Missouri is the only state in the nation with a loss limit on riverboat gaming. The current $500 loss limit is difficult and costly to apply and is easily avoided. The limit prevents Missourians and visitors from participating in gaming to the fullest extent and puts the state's casinos at a competitive disadvantage while not providing an effective deterrent for problem gamblers.

Lottery – $20.8 million

- Implement additional lottery games – $20.8 million. The lottery will introduce a quick draw lottery game into age-controlled environments. This new game will benefit many small businesses and not-for-profit entities. Currently nine other states including Kansas offer these types of games.



<u>Changes in state sales tax law</u> – $34.9 million

- <u>Reduce to 0.5% the timely filing discount on sales tax submissions</u> – $24.9 million. Missouri businesses receive a two-percent discount for sending the sales taxes they collect from consumers to the state. In other words, businesses keep a substantial amount of sales taxes that consumers believe they are paying to government for the services they receive. This discount has been in effect since 1939 and was originally justified on the basis that businesses had to have lots of clerks pushing paper to calculate how much sales tax should be remitted to the state. However, in the Internet age, computers calculate the tax owed by a business and the money can be transmitted to the state in seconds. The two-percent discount no longer recognizes the cost of compliance, and should be reduced accordingly.

- <u>Demand that sales tax refunds be returned to purchasers</u> – $10 million. Currently, a business that applies for and receives a sales tax refund for taxes they have inappropriately collected from customers is not required to even attempt to find and return the overpayment to the purchaser. A cottage industry of consultants has developed to mine businesses for such sales tax refunds. As a result, sales tax refunds have increased from $15.4 million in Fiscal Year 1996 to $67.0 million projected in Fiscal Year 2003. State Auditor Claire McCaskill has identified this abuse of a loophole in our current sales tax law as intolerable.

<u>Tax amnesty</u> – $15 million. The Governor proposes a tax amnesty for a two month period in the fall of 2002. The state has tried a tax amnesty just once in its history. The tax amnesty implemented in the early 1980s during a recession brought in only a minimal amount of money. The failure of that amnesty was due to a number of things including limited advertising. In addition, the earlier tax amnesty was conducted by the Department of Revenue under its limited authority, which prevents the director from waiving interest penalties. Cases currently in court or already identified by the Department of Revenue will not be allowed to participate in the tax amnesty. States that have successfully implemented tax amnesties have allowed for waiving interest and penalties, thus giving individuals and businesses a greater incentive to come forward and properly report their tax liability. The Governor recommends that the General Assembly pass legislation and provide the necessary funding to maximize the impact of the tax amnesty. The Governor cautions the General Assembly not to overestimate the amount the tax amnesty will generate. States that have assumed large amounts from tax amnesty have been disappointed and then have been forced to cut programs funded with the overestimate. The small amount of one-time money estimated by the Governor will be covered by the growth in the other items recommended in this package in Fiscal Year 2004.

OTHER ADDITIONAL RESOURCES FOR LOCAL SCHOOLS

Governor Holden's Fiscal Year 2003 budget includes $3.7 billion in direct state aid to local public schools. In addition to the Foundation Formula, the Governor recommends:

- $6.5 million for Early Childhood Special Education for educational services provided to three- and four-year-old children with disabilities, bringing total state funding to $69.6 million.
- $2.1 million for payments to public schools for students placed by the Division of Family Services or the Department of Mental Health.

TOBACCO SETTLEMENT

In 1998, the National Association of Attorneys General announced a national settlement agreement with five major tobacco companies and Missouri was part of this settlement. In May 2001, Missouri received its first payment of the tobacco settlement proceeds. It is estimated that the state will receive about $164 million during Fiscal Year 2003. Because of the state's current revenue situation, it is not prudent to begin dozens of new programs when existing programs are being cut. The Governor recommends using a portion of the tobacco settlement proceeds to pay for core health care programs while retaining a portion for the most critical investments that will improve the lives of Missourians in the future.

- Tobacco use in Missouri is one of the highest in the nation; 27 percent of adults smoke. Even more alarming are recent studies that indicate one-third of Missouri teenagers are smoking. As a result, Missouri ranks well above average in smoking-related diseases such as heart disease, cancer, and emphysema. Several states have made investments in tobacco prevention and tobacco use reduction programs, especially among teens. To decrease the costly and deadly impacts of smoking and to help contain future health care costs in Missouri, Governor Holden supports Fiscal Year 2003 funding of $22.2 million to support smoking cessation, prevention, and anti-smoking education. These funds will be invested in efforts endorsed by the Centers for Disease Control and Prevention, which have been proven to reduce youth smoking in other states.

- For Missouri seniors, the affordability of prescription drugs continues to be a serious concern. Prescription drug coverage is still excluded from Medicare, and separate insurance to cover prescription drugs is very costly. For seniors with limited resources, choosing which prescription to fill is, unfortunately, a choice they often must make. Some seniors forego necessary medications, leading to increased illness and acute medical costs. During a special session called by Governor Holden, the General Assembly approved the Senior Rx Program to provide drug coverage for seniors with individual incomes below $17,000 or household incomes below $23,000. The Governor recommends $20.4 million of the tobacco settlement payments, along with other funding already set aside, to fund this program.

- Life sciences research will help lead the state to tremendous advancements in the prevention and treatment of diseases and to new uses for agricultural products. Competing with other states and nations in life sciences research is critical to Missouri's economic growth. The Governor recommends a Fiscal Year 2003 investment of $21.6 million for life sciences.

- Missouri has recently made great improvement in access to health care for its citizens. However, it is vital that the state provide a safety net for those Missourians who do not have access to health care through an employer. The Governor recommends continued support of $56.1 million in Fiscal Year 2003 to ensure access to health care for low income Missourians.

- Health care costs are a rapidly growing expenditure for Missouri and all other states. In order to ensure that the state can meet the costs of vital core health care programs, the Governor recommends using $43.8 million from the tobacco settlement to pay these costs.

<u>Opening the Bonne Terre prison</u>

Governor Holden recommends opening the Bonne Terre prison in Fiscal Year 2003. Increasing prison capacity is an essential element to controlling crime. Missouri's crime rate has dropped during the past ten years as the state has increased prison capacity. Missouri's tough criminal sentencing laws have resulted in a prison population that has expanded at a substantial rate over the past five years and had three serious impacts on efforts to manage Missouri prison capacity:

- <u>New prisons have had to be constructed to hold the growing population</u> - In 1994, Missouri prisons could hold 18,162 inmates. By the end of 2001, 12,212 more beds had been added to hold an ever expanding inmate count.
- <u>Due to the rapid rate of inmate growth, older facilities have had to remain on line</u> - Many Missouri prisons have been in existence for many decades and are becoming increasingly expensive to operate due to their inherent inefficiencies and the general costs of aging facilities. Ideally, these prisons should be retired in favor of more efficient and generally less expensive new institutions. However, the rate of inmate growth has not allowed the construction of replacement bed space, only new capacity. The only exception has been the construction currently underway of a replacement facility for the Jefferson City Correctional Center (JCCC) which has been in continuous operation for 166 years. The efficiencies and savings resulting from the new JCCC facility will more than cover the cost of the revenue bond debt incurred to build it.
- <u>Interim housing had to be created and maintained</u> - As a result of inmate growth outpacing actual prison capacity, approximately 1,000 temporary "interim" housing beds have been created and maintained within several Missouri prisons. These efforts include the placement of beds in hallways and tents. Due to the inmate growth rate, currently there is no projected date by which these costly beds can go off line.

If new prison capacity is not added at Bonne Terre in Fiscal Year 2003, the Missouri prison system will run out of space to house offenders during the fiscal year. To address the need for more prison beds, the Governor recommends in Fiscal Year 2003:

- $30 million to open approximately 1,684 beds at Missouri's newest correctional facility, Eastern Reception and Diagnostic Correctional Center at Bonne Terre, Missouri. An additional 1,000 beds will need to be opened in Fiscal Year 2004.
- $10.2 million to maintain the current capacity level at Southeast Correctional Center and open 288 more beds. An additional 444 beds will need to be opened in Fiscal Year 2004.
- $3.6 million to maintain and operate "interim" housing at Algoa Correctional Center, Western Missouri Correctional Center in Cameron, and the Fulton Reception and Diagnostic Center.

In addition, the Governor's recommendations provide funding to improve security and meet the demands of inmate population growth, including:

- $8.2 million for increased medical services.
- $3.8 million federal funds and 13 staff for increased education and substance abuse services.
- $2.1 million and 45 staff for population-based education increases.
- $2.1 million for other inmate population based costs.
- $1.2 million for increased fuel and utilities.

<u>Treatment for Sexually Violent Predators</u>

Persons deemed by the courts to be "sexually violent predators" are committed to the custody of the Department of Mental Health for control and treatment until they can safely return to the community. The courts have also tended to place individuals in the department's custody pending final determination of their status. The program began in January 1999 at the Southeast Missouri Mental Health Center, and the number of individuals detained or committed has been steadily increasing. Governor Holden recommends an increase of $1.4 million for the program in Fiscal Year 2003.

REVIEW OF THE FISCAL YEAR 2002 BUDGET

The State of Missouri finished Fiscal Year 2001 in sound but strained financial condition. Due to a weakening economy and tax cuts enacted in 1999 net general revenue grew only 4.2 percent. Net general revenue completed the year about $98 million below forecast, which was within 1.5 percent of the consensus revenue estimate. Net general revenue collections finished below the consensus forecast due to several factors. The economic downturn that began in the spring depressed sales and use tax collections, which ultimately rose only 1.0 percent. In addition, corporate income tax receipts continued to decline, with gross corporate income tax collections falling nearly 18 percent.

While most economists expected the second half of 2001 to be a period of slow economic growth or even recession, the national economic slowdown became more pronounced last July and August. The weakening economy and slower revenue growth caused Governor Holden to take $323.8 million in budget actions in August. It appeared that these actions coupled with an improving economy would restore stability to the state budget. Unfortunately, this optimism was dramatically altered by the tragic events of September 11th. Among the numerous consequences of the terrorist attacks that day was a substantial decline in economic activity and in the economic outlook. Most economists believe the September 11th attacks caused the U.S. economy to fall into a deeper, more protracted downturn than would have otherwise taken place. The sharp deterioration in economic performance and outlook forced the Governor to once again reduce state spending. Budget actions of $212.2 million were announced in mid-December.

THE ECONOMIC OUTLOOK
U.S. Economy and Outlook

After ten consecutive years of real growth as measured by real Gross Domestic Product (GDP), the U.S. economy fell into a recession in 2001. For calendar year 2001, real GDP growth is expected to be up 1.0 percent overall, considerably slower growth than the 4.1 percent rate seen in 2000. The inflation rate, as measured by the Consumer Price Index, is expected to rise 2.9 percent in 2002. This remains low by historical standards. With the economy weakening, the national unemployment rate is expected to be 4.8 percent for all of 2001 and rise to 6.0 percent in 2002.

The good news is that many leading forecasters, including Macroeconomic Advisers in St. Louis, expect the current recession to be relatively brief, with real GDP growth resuming in 2002. For Fiscal Years 2002 and 2003 the Macroeconomic Advisers forecast is for real GDP to grow 0.2 percent and 2.8 percent, respectively. The inflation rate is expected to be 2.1 percent and 2.3 percent in the two fiscal years. The U.S. unemployment rate is expected to hover around 5.5 percent over the forecast period. This combination of inflation and unemployment will produce a so-called misery index (inflation rate plus unemployment rate) of just under 8.0 percent. While this is an increase, it remains low by historical standards. From 1981 through 1992, the misery index averaged 11.7 percent. While the U.S. economy has weakened since September, recovery in 2002 is expected for the following reasons:

- The Federal Reserve has pursued expansionary monetary policy, lowering interest rates 11 times in 2001.
- The Federal Funds rate has declined from 6.5 percent in January 2001 to 1.75 percent last December.
- Federal fiscal policy has also been stimulative. In addition to the federal tax reductions put in place for 2001 last June, including the rebate sent to taxpayers last August, the federal government has appropriated $40 billion in disaster relief and $5 billion in aid to U.S. airlines since September 11th.
- Oil prices are expected to remain relatively low. The price of imported oil is forecast to be $19.40 per barrel, down from the $25 average seen in 2000 and 2001.
- The stock market has rebounded over the last four months. After falling to 8,062 in the wake of the September 11th events, the Dow Jones Industrial Average has been around the 10,000 level in recent weeks. This has restored a degree of household wealth and consumer confidence.

In summary, the U.S. economy is under strain, but improvement over the next 18 months seems probable. It should be emphasized that this economic outlook assumes that there are no more significant terrorist attacks against the United States or its interests and that the federal government does not institute measures to stimulate the economy that negatively impact state revenue collections.

ECONOMIC PROJECTIONS

	Increase	
U.S.	**FY 2002**	**FY 2003**
Real GDP	**0.2%**	**2.8%**
Consumer Prices	**2.1%**	**2.3%**
Consumption Expenditures	**2.6%**	**4.5%**
Corporate Profits	**-16.4%**	**4.8%**
MISSOURI		
Total Employment	**0.7%**	**0.8%**
Increase in Personal Income	**3.2%**	**4.2%**

The Missouri Economy and Outlook

As was the case with the national economy, the Missouri economy began to weaken during the first half of 2001 and subsequently was further hurt by the September 11th events.

The Missouri unemployment rate in January 2001 stood at 3.7 percent. By December, the seasonally adjusted unemployment rate rose to 4.7 percent. This was a loss of over 46,000 jobs, which included about 25,000 in the crucial manufacturing sector. The sagging economy has also depressed the rate of growth in Missouri Personal Income. After growing by 4.4 percent and 6.0 percent in Fiscal Years 2000 and 2001, respectively, growth of only 3.2 percent is expected in Fiscal Year 2002.

In addition to the weakness seen in these statistics, the Missouri Purchasing Managers Index for December stood at 38.5. This index purports to predict the direction of the state economy. This index has been below 50 for most of 2001, which implies a sluggish economy for the next three to six months.

On January 11, 2002 the Ford Motor Company announced plans to close its assembly plant in St. Louis County by mid-decade. This move will result in the direct loss of 2,640 jobs.

While the Missouri economy is under strain, a modest rebound is expected. The state economy remains diverse with strong presence in health care services, agriculture, as well as the travel and leisure industry. Indeed, employment in health care services has grown from 192,700 in 1990 to 236,800 in 2001. Missouri maintains a very favorable business tax climate evidenced by Missouri's ranking 44th of 44 states that levy a corporate income tax in per capita corporate income tax. As the U.S. economy rebounds, growth in the Missouri economy will likely resume.

REVENUE ESTIMATES FOR FISCAL YEARS 2001 AND 2002

Forecasting revenues is an inherently difficult task, particularly during periods of economic transition and with much uncertainty abroad. Cooperation between the Governor and legislative leaders also remains critical for sound state budget policy. Governor Holden has worked cooperatively with House and Senate leaders to develop a consensus revenue estimate.

The revised Fiscal Year 2002 revenue estimate projects 0.8 percent gross collection growth and –0.6 percent net. The Fiscal Year 2003 revenue estimate projects 2.3 percent net growth over the Fiscal Year 2002 revised consensus revenue estimate.

Revenue Limitation Amendment

Calculations made pursuant to Article X of the Missouri Constitution show that total state revenues for Fiscal Year 2001 were below the total state revenue limit by $447 million. The Office of Administration projects that total state revenues will not exceed the total state revenue limit in Fiscal Year 2002 or Fiscal Year 2003. These preliminary calculations are subject to change as actual revenue collections become known and as the federal government revises its estimates of Missouri personal income. In addition, the recent volatility in the stock market, if continued, could have an impact on this projection. The calculations project that total state revenues will be approximately $807 million below the Article X revenue limit and $893 million below the Article X refund limit in Fiscal Year 2002. It is estimated that total state revenues will be $1.412 billion below the Article X revenue limit and $1.518 billion below the

Article X refund limit in Fiscal Year 2007.
As measured by the state's revenue limit, in Fiscal Year 2002 Missourians are projected to send less of their personal income to state government than at any time since enactment of the limit in 1980. As the federal tax cut phases-in over the next few years and reduces state revenue growth, Missouri's Total State Revenues as a percentage of personal income will continue to fall significantly.

FISCAL YEAR 2002 CAPITAL IMPROVEMENTS BUDGET

Missouri uses a biennial appropriations process for capital improvements. This approach recognizes that most capital improvement projects take two or more years to complete, since significant advance time is required for technical design and the competitive bidding process before actual construction can begin. During the second year of the biennium, funding is provided for critical projects that were not envisioned when the biennial budget was adopted, for completion of projects begun in prior years, and for use of one-time revenues that become available for major infrastructure improvements. The very difficult financial circumstances faced by the state limits the Fiscal Year 2003 capital improvement budget to the following items:

- $30 million in revenue bonds to construct a new state health laboratory.
- $5.3 million in federal funds for planning, design, and construction of a new armory in the southern portion of the Kansas City metropolitan area.
- $540,000 in federal funds for planning and design of seven new community corrections centers.

FISCAL YEAR 2003 COMPENSATION PLAN

To deliver high-quality services, the state must be able to compete for qualified, high-performing employees at all levels of government. State employee compensation policy is faced with two problems. First, state employee salaries are on average 13.8 percent below the market rate. The table below shows how employee salaries compare to the market based on various surveys and indexes.

Second, the average percentage by which all classes are behind the market masks the fact that some jobs are paid at the market rate while others lag by more than 20-25 percent. This wide disparity makes it difficult for the state to recruit and retain employees in many job classes. Governor Holden is committed, with available funds, to providing fair and equitable compensation in state government to reward and retain productive employees. Although in Fiscal Year 2003 state revenue growth will not be sufficient to support a general compensation increase for state employees, a significant increase for employees' health care benefits is recommend by the Governor.

- $18.5 million, including $12.9 million general revenue to continue the current state subsidy level for employee health care benefits through calendar year 2002.
- $3.1 million general revenue to fund the start of Senate Concurrent Resolution 27 (2001), basing the state contribution toward retiree health care premiums on an employee's length of service with the state. This tenure-based subsidy policy is meant to add value to the current benefits package and to encourage employees to continue in state employment with a career goal of 30 years of state service.
- $5.6 million, including $3.9 million general revenue to set up a reserve for a self-insured HMO plan for certain areas of the state that aren't well served under existing contracts.

Survey/Index of Comparison	**Cumulative Growth since July 1990**
American Compensation Assoc. Survey of Compensation	**56.0 percent**
Employment Cost Index	**46.9 percent**
Consumer Price Index	**36.1 percent**
State Employees - Uniform Classification and Pay System	**40.0 percent**